HUTCHINSON
CAPITAL
MANAGEMENT

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INVESTMENT PERSPECTIVES

Measuring Management

Nearly every investor agrees that strong management teams are an important driver of longer-term returns but how exactly does an investor judge management teams and how much weight should be placed on this criteria? With the benefit of hindsight, the judgment process is quite easy – take a look at stocks that have done well for the past 10-15 years and many times such companies were run by strong management teams. But how do we analyze current management teams as we try to identify companies for the next 10 years?

One way we can do this is to study their incentives through reading an often underutilized company filing called the Proxy Statement (proxy). The proxy is an SEC (Securities and Exchange Commission) document that must be issued annually by a public company to keep shareholders informed of issues to be brought up at the annual meeting. The various sections of the proxy provide clarity on the following issues:

- Appointments to the Board of Directors
- Management Team and Expertise
- Compensation
- Major Shareholders including Insider Ownership

The proxy is far from a straight forward document. We wonder if the lawyers and consultants who craft these documents purposely make it difficult to extract useful information. But after cutting through the haze of legalese, we are struck by how average to below average (from a shareholder's perspective) so many proxies appear. At HCM, we have no problems with high levels of compensation for strong long-term results. Neither running a multi-national company with several operating divisions nor dealing with employees, regulators, shareholders, and all other stakeholders is easy work. If a management team can deal with all these contingencies and drive shareholder value, the team deserves the rich compensation and maybe much more. We struggle when management teams have win/win situations – if shareholders do well, management is paid very well; if shareholders do poorly, management is still paid very well. When shareholders lose, management teams should have "at risk" pay. "At risk" pay is an important concept so executives feel like stock and option bonuses are truly incentive based compensation - not a handout for showing up.

We also marvel at the tight relationship between company size and total executive compensation. There is a belief that the larger and more complex the organization, the more money an executive should be paid. Unfortunately for shareholders, size does not necessarily correlate with shareholder returns although it virtually guarantees more money for the executive teams. Proxy readers should remember that averages, medians, and relative comparisons can be meaningless if everyone is egregiously overcompensated. By way of comparison, one has to wonder whether a car enthusiast would really be terribly troubled at the prospect of a test drive with a 'median' or 'below average' vehicle from the local billionaires' Ferrari Club.

So is there anything worthwhile when digging through a proxy? Certainly, we like to see executives with skin in the game – substantial ownership of stock is normally a big positive but we recognize that many well-run larger capitalization companies can have lower ownership levels. We want compensation tied to appropriate benchmarks of success for a particular industry, with a preference towards metrics that are based on returns on investor capital. For the leaders of individual business segments, we prefer targets based upon a combination of segment and total company success. We are less enthralled with softer measures based on qualitative assessments provided by other company managers as these always seem to skew positive and are more difficult to reconcile with shareholder returns. We also want metrics that evaluate a team over a number of years as opposed to incentives that solely base payouts on a single year of performance – executives in the financial services industry who executed well in 2006 might have looked quite different during 2008-2009.

In addition to the proxy there are other factors we consider in evaluating management. As value investors, we believe that a stock represents a fractional ownership stake of a real business. Over the long term the value of a business is determined by management's ability to make fundamental decisions that either *creates* or *destroys* value. Since we invest with a multi-year time horizon we consider the management team to be our "partners" because they are the operators of the businesses in which we choose to invest. A company's management team resembles an investment manager in the sense that management (or investment manager) invests capital (or a portfolio) on behalf of shareholders (or clients) with the expectation of generating a satisfactory rate of return. Some of the critical capital allocations decisions management decides include: capital expenditures, dividend policy, share buybacks, mergers and acquisitions. We believe that it is important to evaluate capital allocation decisions not just in the current economic environment but also during different stages in the business cycle (e.g. economic expansions and recessions). In doing so, we attempt to assess potential patterns in management decision making that could provide clues as to how management might act in the future.

Questions we try and answer in our assessment process include:

- How does management decide on whether to pay dividends, repurchase stock, or pursue acquisitions and how do we view their historical track record on these decisions?

- Are current returns on capital higher or lower returns than in the past? Why?

- Are shareholder letters mindless repetition of financial metrics/corporate propaganda or do they actually try to convey an honest assessment of successes and failures?

While in our research efforts we analyze various financial and operating ratios for a particular company and industry, frequently our assessment of management is more from a qualitative versus a quantitative perspective. Generally, it is more difficult to find a single manager who is brilliant in both operations and capital allocation and therefore we look to the entire management team and corporate history for clues on effective capital allocators. Often, the manager who has historically driven returns at a single operating division is promoted to Chief Executive Officer and finds himself/herself woefully unprepared when trying to decide whether to repurchase stock or pursue a larger acquisition. Just as in the investment process, group think can often prove problematic in corporate boardrooms. Momentum, partially aided by outside consultants and investment bankers, drives decisions regarding transformative acquisitions or even leveraged share repurchases at market highs, followed by thumb sucking when company shares languish far below any reasonable assessment of intrinsic value. In the vast majority of cases we speak directly with the companies in which we invest and we strive to understand the thought process and rationale behind management's critical capital allocation decisions. As a first choice, we seek to invest with management teams that are forthright, long-term focused, and strong stewards of shareholder capital. In cases where capital allocation mistakes have destroyed value, we weigh possible capital allocation concerns against the investment's margin of safety.

As previously outlined, ideally, we look for situations where management incentives are properly aligned with metrics that will also benefit shareholders. As we stated in our March position paper on Markel Corp. (Markel), there is a strong relationship between an insurers' book value (net stockholders equity divided by outstanding shares) per share and its stocks price. If the former grows, the latter should eventually trace this advance, although the exact valuation multiple will depend on a variety of factors. Additionally, the book value of an insurer relative to its asset and premium base will give information about its capital strength and the ultimate amount of business the company can eventually underwrite. Relative to its size and to other insurers, Markel pays its executives modest base salaries, with 100% bonus payouts tied to the company achieving a 5 year compounded annual growth rate (CAGR) in book value of 16% per share and no bonus if the 5 Year CAGR is below 6%. In our opinion, this longer-term target exceptionally aligns management incentives with the goals of shareholders.

Furthermore, Markel does not award stock options. Instead management receives restricted stock that only vests at the end of a five year period (cliff vesting versus annual vesting). Despite achieving a five year compounded growth in book value of 9% for the period ended December 31, 2012 (during a period of low interest rates and more difficult equity markets), Markel CIO, Tom Gayner, and COO, Richard Whitt, took no cash bonuses in 2008 and 2011 while Vice Chairman Steven Markel voluntarily rejected any stock award from 2008-2012. While Markel's executives "only" own approximately 4.0% (pro-forma for the Alterra acquisition) of the company, we would note that this equity ownership represents a substantial portion of their individual net worth and multiple executives purchased Markel stock in the open market after the Alterra acquisition announcement. While we are constructive on the insurance industry for a number of different reasons, we were particularly attracted to Markel because of the sharp alignment of management incentives and drivers of shareholder returns. In short, Markel's proxy checked off nearly everything we'd look for in such a document and was a major part of our investment decision.

Investing, like life, is never straightforward. It would be fantastic if every holding's proxy looked similar to Markel's and all had incentives that were perfectly aligned with shareholders. Some attractive investments, however, have rather average management teams. When perusing Microsoft Corporation's (Microsoft) proxy, a reader might be struck by the huge insider ownership (relative to other mega-cap names) and the relatively modest base salary of the CEO. Steve Ballmer owns over 333 million shares in the company, and he has voluntarily elected not to receive equity bonuses. Other executives have reasonable sounding incentives tied to company and segment operating performance with 3 year vesting periods, and therefore a reader only considering the proxy might come away impressed with the Microsoft management team.

We have a slightly different take. Given the ownership size, if Microsoft's stock (which closed at $34.54 on June 28, 2013) were to trade at $20, Ballmer's stake would be worth $6.7 billion while at $50, the shares would be valued at $16.7 billion. We would submit that Mr. Ballmer will be immensely wealthy in either scenario. Given our cost basis, there is a material difference between these two outcomes. And given the capital allocation decisions over the past decade (inconsistencies between buybacks and dividends, a $45 billion bid for Yahoo!, the $8.5 billion purchase of Skype) and little management incentives tied to per share metrics and targeted returns on acquisitions, we question how closely shareholders' interests have been aligned with management.

But we recognized these inconsistencies in February of this year and we still purchased the stock. Why? Because we believed the cash flow generation of the Office and Server divisions was so substantial that there was valuation support for the stock even if some truly ugly things materialized for other parts of Microsoft's businesses. We also believed that the continued divergence in stock performance relative to cash and cash flow per share grow could put increased pressure on the current management team.[1] For all the talk about whether PCs are dead or whether Microsoft can innovate or not, we still

[1] Activist investor ValueAct Capital disclosed a $2 billion stake in Microsoft in April of this year. It is unclear the exact intentions of the firm, but there have been rumors that the firm will push for a seat on the company's board.

believe that astute capital management is likely the key catalyst for determining whether Microsoft's valuation multiple expands over the next couple of years. Taking a page out of IBM's playbook[2], a proxy which gave incentives based upon the company hitting certain per share target 3-5 years from now (specifying a certain amount of buybacks, dividends, and acquisition activity) could do far more for MSFT's stock than whether or not its latest Surface tablet gets sufficient market share or not. To paraphrase Winston Churchill, we are hopeful that Microsoft can eventually get the capital allocation process correct, as it has tried nearly every other possibility over the past decade.

In summary, we recognize there are no magic bullets in evaluating management teams. We look at a variety of factors in forming an opinion and make a rational judgment based upon a series of quantitative and qualitative metrics. HCM knows that mistakes will be made in our management evaluation process, just as we know that we will make mistakes on individual security selection. However, by strengthening our due diligence process, we continue to improve our evaluation process and ultimately strive to find stronger, long-term partners in managing the capital entrusted to us. We think these improvements can further refine our research process and provide the best long-term results for our clients.

PLEASE SEE IMPORTANT DISCLOSURES BELOW:

As of June 30, 2013, Hutchinson Capital Management (HCM) held:
30,557 shares of Markel Corp. (MKL)
524,463 shares of Microsoft Corporation (MSFT)
3,605 shares of International Business Machines Corporation (IBM)

As of June 30, 2013:
Markel closed at $526.95
Microsoft closed at $34.54
IBM closed at $191.11

As of June 30, 2013, the following were the ten largest holdings of HCM:

Name of Issuer	% of Equity Portfolio	06/30/13 Closing Price
GENERAL MOTORS CORP.	6.22%	$33.31
MICROSOFT CORPORATION	6.09%	$34.54
JOHNSON CONTROLS INC	5.98%	$35.79
WELLS FARGO & CO	5.96%	$41.27
CVS CAREMARK CORPORATION	5.46%	$57.18

[2] IBM has offered a roadmap to achieve over $20 in operating EPS by 2015, with the company describing how much of this growth will come from organic revenue versus acquired revenue, the amount of expected operating leverage, and how much capital will be allocated to dividends and buybacks. This multi-period guidance provides investors considerable clarity into how the company thinks about capital allocation decisions.

OMNICOM GROUP INC	5.46%	$62.87
BANK OF NEW YORK CO (New)	5.39%	$28.05
MARKEL CORP COM	5.34%	$526.95
EMERSON ELECTRIC CO	4.88%	$54.54
CHUBB CORPORATION	4.56%	$84.65

For a complete list of holdings, please see our most recent 13F filing on the following SEC website: http://www.sec.gov/edgar/searchedgar/companysearch.html

HCM's investment decision making process involves a number of different factors, not just those discussed in this document. The views expressed in this material are subject to ongoing evaluation and could change at any time.

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